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## China's macroeconomy in transition

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### **Abstract:**

*China's macroeconomic problems and their effect on economic stability and growth are examined, including the shrinking of state enterprises in the face of new competition and a corresponding decrease in state investments.*

### **Full Text:**

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Is macroeconomic stability the Achilles heel of the Chinese economy? Recurrent bouts of inflationary disorder lead some observers to worry that the Chinese government is unable to control the economy. Macroeconomic difficulties show up in a pattern of repeated boom and bust cycles, in which each boom is accompanied by an acute inflationary phase and significant disruption. Moreover, since the reform era began, the peak annual inflation rate of each successive cycle has been higher than that of the preceding one.(1) The most recent attempts to cool off the economy have only led to additional questions. An **austerity** policy was decreed at the end of June 1993, yet inflation actually accelerated in 1994, and it was not until mid-1995 that it dropped to the levels of mid-1993. The Chinese government was engaged in a quest for an economic "soft landing" for two years without a net reduction in the inflation rate!

Macroeconomic issues also attract attention because of their link to broader questions about the future of Chinese society. For centuries, China has been plagued by the two extremes of dictatorship and chaos. Today, it has thrown off the main institutions of economic dictatorship the system of central planning - and has created the rudiments of a market economy. But it is possible that the improved economic conditions produced by reform will be threatened by a descent into economic chaos? More broadly, it is obvious that the Chinese political system has not achieved real legitimacy or widespread support among the population. The current government is woefully inadequate to cope with the growing diversity and emergent political demands of Chinese society. In this context, macroeconomic instability often seems to stand in for the spectre of broader social unrest. During the period when the government is temporarily able to maintain direct political control over a changing society, macroeconomic weakness is brought in to demonstrate the paradoxical weakness that shadows this apparently strong government.(2)

Even on more narrowly economic grounds, it is common to view China as lacking the macroeconomic institutions required to manage a market economy, thus having little protection from economic disorder. Economics-based approaches may stress the relative strength of local governments and their client enterprises(3); or they may deduce problems from the evolution of macroeconomic magnitudes such as central government budgetary revenues (which are declining) or central bank lending (which fluctuates but is sometimes large).(4) These views are useful in directing attention to a crucial unresolved area in China's economic reform process. It is indeed true that reform of the institutions of

macroeconomic control is currently the most urgent need in the reform process, as well as one of the most difficult. However, this article argues that it is simply not the case that the Chinese central government is a feeble state, bereft of effective instruments of macroeconomic control and doomed to a process of economic disintegration. Indeed, anyone who sees the Chinese central government solely as a weak government is seriously misperceiving the situation. Instead, the Chinese central government combines paradoxical elements of strength and weakness, and attempts to achieve multiple and sometimes conflicting objectives, including some that require ambitious intervention in the economy.

This combination of conflicting and paradoxical elements often results in inconsistent or destabilizing policies. But there is nothing in the fundamental characteristics of China's macroeconomy that dooms the effort of reformers to establish a stable and consistent policy package. The macroeconomy is not the Achilles heel of the reform process. Instead, it is argued that the quest for macroeconomy stability should be seen as an inherently extremely difficult process in a transitional economy. On balance, China has done reasonably well: probably better than anyone had any right to expect. But there are still serious challenges facing policy-makers, and these challenges will become much more formidable if the political process breaks down after the death of Deng Xiaoping.

This article addresses a few of the many issues relating to Chinese macroeconomic policy. The first section details the basic conditions that structure China's macroeconomic problems. Most important is the remarkable shrinkage in the size of the state budget, caused by the rapid entry of new firms that has led to increased competition and the erosion of the previously protected monopoly profits of state-owned enterprises (SOEs) in industry and trade. This process has also led to a distinct division of labour between state and non-state firms across industrial sectors. The second section shows that the retreat of the state from most spheres of the economy has not been accompanied by a similar reduction in state fixed investment. On the contrary, the state has maintained a vigorous and intrusive role in investment, actually growing in the past few years (1992-94). In the third section, the enormous pressures on the banking system created by shrinking state revenues and large state investment are described. The fourth section discusses two other problems that disrupt macroeconomic stability: deficit SOEs and new problems related to the maintenance of external balance. The final section includes a few predictions about future policy and stability.

The article's conclusions can be summarized as follows. First, the overall process of macroeconomic policy-making does not reveal a government bereft of effective instruments. Rather, it shows a government whose policies are clumsy and often delayed, but which eventually responds and achieves results. Secondly, because current problems are difficult and are not about to disappear, continued recurrent inflationary bouts and instability can be expected. This is not because the government is without instruments, but because it is subject to intense, often contradictory, pressures in complex situations, and will inevitably make mistakes. Thirdly, financial reform is a focus of current contradictions and the main area where radical economic reforms are needed. Many of the required measures and institutions have been proclaimed - such as central bank independence - but the point is to make them actually work. When it is considered that the key economic fundamentals are in place - with high domestic saving, rapid growth and the institutional outlines in place - there are some grounds for optimism despite the formidable problems.

### The Context of Evolutionary Reform

Even in a developed market economy, macroeconomic policy-making is difficult and often surrounded by controversy. In the United States, the Federal Reserve Board possesses abundant sources of information and controls powerful instruments to intervene in sophisticated capital markets. Moreover,

the Federal Reserve Board possesses a relatively straightforward and unitary objective: maintaining price stability. Despite these advantages, hundreds of millions of dollars are spent annually anticipating and placing wagers on policy moves by "the Fed." In a formerly socialist transitional economy, little of the sophisticated institutional apparatus of macroeconomic policy implementation is available. The absence of well-functioning institutions not only makes it more difficult to achieve price stability, it also complicates the overall process by requiring policy-makers to pay attention to multiple objectives. While policy-makers in China or other transitional economies strive for price stability, they must also foster new financial institutions. Fundamentally, financial institutions exist to channel saving into investment, which is necessary for economic growth. Yet in the course of reform, these institutions must undergo massive change. Macroeconomic policy-makers must thus strive for price stability, insure investment finance through existing institutions and reform those institutions. Inevitably, these complex objectives generate conflicts.

The basic context within which the changing role of planners and macroeconomic institutions in China must be placed is the process of marketization and the overall evolutionary reform strategy of "growing out of the plan."<sup>(5)</sup> In the unreformed economy, planners had direct control over saving and investment. Virtually all national saving was carried out in the state sector, more particularly in state manufacturing enterprises. Those enterprises operated in a protected environment, with prices set at generous levels by the government, and they earned very large profits. They remitted almost all their surpluses to the government budget. Household savings were small, so the allocation of government investment funds by the central planners basically determined the economywide balance between saving and investment. What is traditionally thought of as monetary policy (supply of money and credit and establishment of interest rates) was not very important in the planned economy. Prudent fiscal policy was all that was required, and in practice this meant setting the growth of state investment at sustainable levels.

The most crucial step in economic reform was the ending of the government monopoly over the economy, and especially over industrial production and investment. The industrial system was changed by entry of new producers, including township and village enterprises, private firms and new locally-run state firms. Not surprisingly, entry was most rapid in those sectors where profits were high, as was true generally in manufacturing. Competition eroded the huge surpluses that state firms had been accustomed to earning, thus upsetting government budgets and the entire balance of saving and investment in the economy. Many of the government institutional and policy changes that marked the reform era can be seen as responses to this changing environment.

1. Inflation, as measured by the retail price index, peaked at 5.0% in 1985, 8.8% in 1986, 18.5% in 1988 and 21.7% in 1989.

2. Karlene Harford, "The political economy behind Beijing Spring," in Tony Saich and J. Hui (China Press), *Macroeconomic Perspectives on Spring 1989* (Albany, NY: M. E. Sharpe, 1989), pp. 50-63. Harford's nuanced arguments become gristmills in Richard Smith, "Shocking China's bubble: the Middle Kingdom," *Foreign Affairs*, Vol. 71, No. 1 (1991), pp. 20-42.

3. For example Christine Wong argues, "In the 1990s, the serious hold of the central government over macroeconomic control is under assault, with traditional administrative

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control system ... rapidly losing priority, while effective indirect mechanisms are slow to develop. Local governments have led this attack. "China's economy: the limits of gradual reform," in William A. Joseph (ed.), *China's Reform 1984* (Oxford: Clarendon Press, 1990), p. 90.

4. A recent World Bank report, *China's Economy: Macroeconomic Macroeconomic Indicators in a Decade of Reform* (20 October 1994), argues that People's Bank of China (PBC) leading enterprise's hidden budget deficit and attempts to control it, PBC leading to state banks has been large since 1988, but control to 8.7% of GDP in 1993. The World Bank authors state that 60.46% of this is for "policy loans" (i.e. government indirect spending) and evidently to an additional deficit spending (see p. 28, below).

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With this came massive change in the role of the government budget. In 1978, government budgetary revenues at all levels came to 35.5 per cent of gross national product (GNP); according to preliminary figures, in 1994 the comparable figure was only 12.7 per cent.<sup>(6)</sup> Scaled to GNP, budgetary revenues have fallen steadily to about one-third of their 1978 level. Under the pressure of this erosion in revenues, budgetary expenditures have been cut back as well. Overt deficits have been kept to moderate levels: between 2 and 3 per cent of GNP in most years, including 1994. Deficits of this size are not in themselves enough to destabilize an economy, but they are enough largely to eliminate the ability of

policy-makers to use "fiscal policy" to affect the macroeconomy. Policy-makers don't have the revenue available to reduce the deficit, and they don't dare run a larger deficit for fear that this would signal economic difficulties. Budgetary authorities have therefore been forced to resign themselves to simply managing the decline in revenues and expenditures in an orderly fashion.(7) Previously, only fiscal policy was important; since reform, fiscal policy has been rendered impotent. By contrast, whereas monetary policy used to be fairly trivial, today only monetary policy can really matter for macroeconomic stability.

5. Barry Naughton, *Controlling the Plan: Chinese Economic Reform, 1978-1984* (Cambridge: Cambridge University Press, 1995).  
6. Liu Zhongyi, "Thoughts on the implementation of the state budget for 1994 and on the draft central and local budgets for 1995," *Beijing Review*, 3-15 April 1995, pp. 51-52. (Emphasis added.)  
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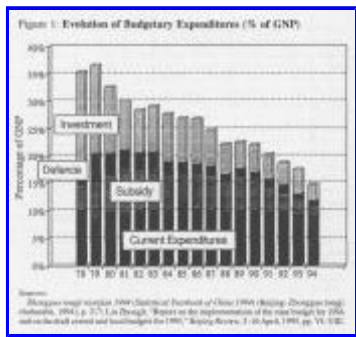
Since revenues and expenditures are closely related, Figure 1 displays only budgetary expenditures. Two facts emerge clearly. First, the reduction in overall budgetary outlays has been massive and sustained: from 35 per cent to just below 15 per cent of GNP. Secondly, perhaps even more surprisingly, the changes have had very little overall quantitative impact on what might be thought of as "ordinary government," that is, the category of government expenditures labelled "current expenditures" in Figure 1. Reductions in expenditures have been concentrated in investment, **defence** outlays and subsidies. Budgetary outlays for investment were at their highest in 1978 at 16.2 per cent of GNP and have declined steadily since to only 2.7 per cent of GNP in 1994. Military expenditures peaked in 1979 at 5.6 per cent of GNP and generally declined - notwithstanding a blip in 1989-90 - to 1.3 per cent of GNP in 1994. And subsidies - lumping together price subsidies and subventions to loss-making SOEs - peaked in 1981 at 8.2 per cent of GNP and declined to 1.5 per cent of GNP by 1994.(8) By contrast, government current expenditures have been maintained at almost exactly 10 per cent of GNP throughout the entire reform era.(9) Thus, despite the dramatic decline in revenues, the share of GNP going to administration, education and other ordinary government has been sustained.(10)

The majority of the decline in budgetary revenues is clearly as a result of remittances from industrial SOEs plummeting. Until the end of 1993 this decline was understandable given the absence of tax reform and the continuing reliance on the old budgetary system, under which SOE profit remittances funded the bulk of government activities. Since 1 January 1994, however, a new tax system has been established that nominally has many of the desirable characteristics of a modern system. It creates a nearly uniform value-added tax and a profit tax that applies equally to all ownership forms.(11) However, it has thus far been unable to slow the fall in government revenues. Not only did 1994 continue the pattern of declining revenues established in previous years, there are also ominous signs that revenue collection in the first half of 1995 was even slower than in 1994.(12)

7. In fact, since Chinese policy-makers are in the same position as American policy-makers, in those of most other countries. They too continue to be essentially able to use fiscal policy as a flexible instrument of overall macroeconomic policy.  
8. There are numerous issues relating to budgetary data that cannot be discussed here. First, military outlays are substantially greater than budgetary data reveal, both because the military controls a share of the books and because some military expenses are "hidden" under other headings. In addition, Chinese budgetary data do not cover social security expenditures for SOEs which are significant. There are many types of "extra-budgetary" funds, the majority of which are not included in the budgetary system.  
9. The difference in the balance of different functional components of expenditures is a reflection of the changing nature of government activities. The central government is responsible for more investment and defence, while local governments are responsible for most current expenditures. This reflects the increasing role of local governments in the economy.  
10. It is clear that the share of GNP allocated through the budget to education, health and other expenditures has increased, and that maintenance of the per capita share of GNP is important. The point here is simply to argue that, on balance, these outlays have been sustained from the same source of existing budgetary revenues.  
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Figure 1: Evolution of Budgetary Expenditures (% of GNP)

As described above, it might appear that the decline in budgetary revenues was a purely negative phenomenon: government saving declined, and fewer resources were available for public investment and services. There was, though, another side to the story. By permitting entry into lucrative manufacturing and trade sectors, the government created new opportunities for private and local interests, and investment by households and non-state enterprises increased. In order to finance those investments, these entities increased their saving as well, and this compensated for much of the reduction in government saving.(13) Non-state firms stepped up their internal saving as SOEs were forced to reduce theirs. As these decentralized entities invested more in the economy, they took over many activities that had previously been dominated by the government. Thus although the government had fewer resources to invest, the need for it to finance all types of investment was eliminated. Moreover, the economy benefited from de-monopolization. It became more diverse and resilient, and developed stronger self regulating mechanisms, as some decisions were taken out of the hands of central planners.

New division of labour. The result has been the emergence of a de facto division of labour between competitive sectors with investment from non-state enterprises, and non-competitive (or not fully competitive) sectors that continue to be dominated by state investment and especially by central government activity. This division of labour began to emerge in the early 1980s, and developed steadily in the 1990s. Figure 2 displays one way to look at it. Industrial sectors are arranged in three groups, roughly according to the share of SOEs in gross output.(14) At the top are the non-competitive sectors, in which state output is dominant. Most prominent are the natural resource sectors and utilities, where the government has simply decreed that SOEs will retain a monopoly or near-monopoly position. The remaining sectors are the heavy materials industries that exhibit substantial economies of scale (such as steel and chemicals). In these sectors, the entry of new producers has not fundamentally altered the ownership structure, because of both administrative regulation and economic factors.

A second group comprises three sectors - tobacco, food processing and beverages - in which SOEs are still extremely important. The government continues to control a large part of the agricultural procurements required as inputs, and it reserves these inputs for SOEs. In some cases, such as cigarettes, the national government intentionally maintains control in order to protect revenues. In other cases control is decentralized, but local agencies cling to it to generate revenues for client enterprises. As a result of these lingering distortions, these sectors are not fully competitive either.

13. Yang Shouxi and Chang Fuh-shen, "China's new reform of 1990: breakthrough or compromise?" Asian Survey, Vol. 34, No. 9 (September 1994), pp. 768-788.  
14. "China shows early signs of moving toward goal," Kinetic, 15 July 1991, [chinaonline.com](#).  
15. Houghton, *Growing Out of the Plan*, pp. 141-46.

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The third group is the competitive sector which makes up the largest part of Chinese industry. The sectors classified as competitive make up 53 per cent of industrial output in the data shown in Figure 2,

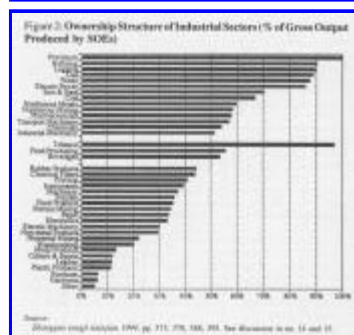


and an even larger proportion of total industrial output including very small-scale firms. The share of competitive sector output produced by SOEs is quite modest: only 27 per cent of the covered output. Yet these competitive sectors account for fully 71 per cent of the output of non-state firms covered. Put another way, a large majority of non-state industrial output is in the competitive sector, which is most of Chinese industry. Conversely, a large majority of state industrial output is in non-competitive sectors: these account for more than two-thirds of SOE output and SOEs produce about two-thirds of the output of these sectors. The non-competitive sectors represent a minority of Chinese industry, but account for the bulk of resource extraction, utilities and capital intensive materials industry. In this respect, the Chinese state sector is beginning to resemble the state sector in other mixed market economies, with a strong tendency to concentrate on infrastructure and a few heavy industrial sectors.

This division of labour occurred as the result of a complex process. On one hand, new entrants were able successfully to out-compete state firms in some competitive sectors. Output of competitive sectors grew and the need for government investment there was reduced. On the other hand, with robust economic growth, the need for government investment in public goods and infrastructure increased. The result was pressure on government to concentrate investment on infrastructure provision and strategic industrial sectors. The initial government response stressed primary energy production (given China's severe energy crisis in the early 1980s), but gradually the emphasis shifted to infrastructure. Central government planning did not cease, but it was focused on a narrower range of activities, the scope of which was determined by the growth of market forces.

16. Chinese authorities do not publish a breakdown of all industrial output. The data in Figure 2 are calculated by summing the data on independent accounting enterprises and village-level enterprises, for which national and provincial breakdowns are available. Ownership structure 1994, pp. 371, 378, 388, 395. The data shown account for 93% of all industrial output. SOEs account for 40% of this output, compared with the 37% of total output they are known to account for. 10% of the output included from Figure 2, SOEs account for only 30% and non-state SOEs, mostly small-scale private firms, account for 90%. Compare Richard F. Johnston, *Reform and Structural Change in the Chinese Economy: A GDP Analysis*, Ph.D. Dissertation, University of California, Berkeley, May 1999, pp. 182, 186-187.

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Figure 2: Ownership Structure of Industrial Sectors (% of Gross Output Produced by SOEs)

## Intervention in Investment

Does the rapid decline in government (and SOE) saving and state investment financed through the budget, as documented above, mean that overall investment in state-owned units declined as well? In fact, contrary to what might be supposed, overall state investment has remained large and even increased in the 1990s. The contrast between high and rising state investment and low and declining state financing for investment represents the fundamental conflict underlying macroeconomic policy decisions. This section examines overall quantitative trends in government investment, their sectoral impacts and the implication for understanding central and local government roles in the economy.

Quantitative investment trends. From a starting point in 1978 where nearly all fixed investment was in the state sector, the state share of fixed investment first dropped quickly and then declined more slowly until the end of 1988. However, this reduction was not sustained. In 1985, the state accounted for two-

thirds of both total fixed investment and total industrial output. After 1989, the state share of industrial output continued to decline, reaching 40 per cent in 1994, but its share of investment remained stubbornly high, and even increased to 69 per cent in 1994.<sup>(15)</sup> A significant part of this investment, particularly during the 1990s, went to support infrastructure construction. China has experienced extremely rapid rates of overall economic growth, which would have been inconceivable without generally adequate provision of infrastructure. Although bottlenecks have repeatedly re-emerged under the pressure of rapid growth, government investment has generally been sufficient to overcome them and prevent growth from faltering. Adequate provision of infrastructure must be considered the second key element of successful Chinese growth policy, along with vigorous entry and investment in competitive sectors. These have enabled a self-sustaining growth process to become established during the course of transition from a planned to a market economy.

Figure 3 provides a general view of government investment in physical infrastructure and social sector fixed capital.<sup>(16)</sup> Infrastructure investment (physical and social) surpassed 5 per cent of GDP in 1984, and has been maintained at that level since, except in 1989. Since 1992, spending of this type has grown extremely rapidly, and it reached 8 per cent of GDP in 1993. Excluding the social sectors, physical infrastructure expenditure reached 6.5 per cent of GDP in 1993, well above the average of developing countries (4 per cent) and close to the 7 per cent "recommended" by the World Bank.<sup>(17)</sup> Only in the social sectors has performance seriously lagged: investment eroded from 1.3 per cent of GDP in 1985 to only 0.9 per cent in 1993. Weak social sector investment is attributable to the state's continuing fiscal difficulties and the absence of alternative financing arrangements.

Central and local government investment. The pattern of a continued high level of state investment requires a closer look at the role of central and local governments, since both are included in the general category of state investment. The categories of "central" and "local" are not symmetrical. Central government investment is co-ordinated through the State Planning Commission, generally reflects central government policy and is roughly equivalent to government investment in other developing countries. By contrast, local investment in state-owned units is the aggregate of investment by local governments as such (for example, urban infrastructure investment), and of state-owned enterprises nominally under the authority of local governments.<sup>(18)</sup> In practice, many of those state-owned enterprises have gained substantial autonomy in recent years, and their activities correspond to that of parastatals in other developing countries. Moreover, local state-owned unit investment includes investment under the supervision of governments ranging from provinces - which have populations of up to 110 million people - down to counties and even occasionally townships with total populations of only 100,000. It is thus exceptionally difficult to generalize about local state investment in China.

A majority of state investment is local: about 60 per cent in recent years, but slightly higher in 1993-94. Despite ongoing decentralization, central government investment has remained substantial. In 1978, before reform began, investment in central government projects amounted to 8.7 per cent of GDP, and in 1993 it was 8.6 per cent; 1994 preliminary figures indicate a similar 8.3 per cent (see Figure 4). Local government investment increased significantly early in the reform era, and it also fluctuates more than that in central government. Before reform, in 1978, investment in local government projects was 9.9 per cent of GDP, and after considerable fluctuation equalled 17.0 per cent of GDP in 1994. Together, central and local governments invested a whopping 25.3 per cent of GDP in state-owned units under their control in 1994 (down slightly from the total in 1993). These state investment rates are higher than any other period of the PRC outside the Great Leap Forward.<sup>(19)</sup>

The sectoral composition of central and local state investment differ substantially. The Centre devotes 37 per cent of its investment to infrastructure, including the bulk of that in power and telecom; in

addition, it provides nearly all of that in primary energy (coal, gas and oil), which accounts for 23 per cent of its investment. Some 12 per cent of its investment is spent on scientific research and "other," both of which presumably involve national security. As a result, in the central government's investment outlays, infrastructure, primary energy and "science and other" together account for 72 per cent. Only 28 per cent is available for all other uses, and in practice much of this is taken up by investments in industrial sectors characterized by substantial economies of scale: metallurgy, chemicals and transportation equipment. The central government invests almost nothing in the competitive sectors shown in Figure 2. By contrast, local governments commit almost nothing to primary energy and "science and other," and about 25 per cent to infrastructure (especially transport, water and social infrastructures). In total, only 30 per cent of state investment under local control goes to infrastructure, energy, and "science and other." Locals have 70 per cent available for other uses, and while they also invest in metallurgy, chemicals and machinery, they have substantial funds available for competitive sectors.

Strengthening of traditional planning organs. One consequence of the increased level of government investment in the 1990s has been a strengthening of the traditional planning organs, especially the State Planning Commission (SPC), where until 1989 the tendency had been for these to lose influence. The traditional plan was frozen and then shrank, greatly limiting the discretionary power of the State Planning Commission. At the same time, alternative centres of economic expertise and forecasting advice developed in the semi-autonomous "think tanks" set up under Zhao Ziyang's auspices. Since 1989, though, planners have become more confident and more interventionist. They have sought to reinvent themselves as guardians of the public interest and agents of a national industrial policy, based on their interpretation of Japanese and Korean experience. Industrial policy has been popular - at least within government - and the SPC has been able to ride a "hot" agenda item back into political influence. In addition, the SPC's renewed influence reflects the weakening, and in some cases elimination, of alternative centres of economic policy-making advice in the wake of June 1989.

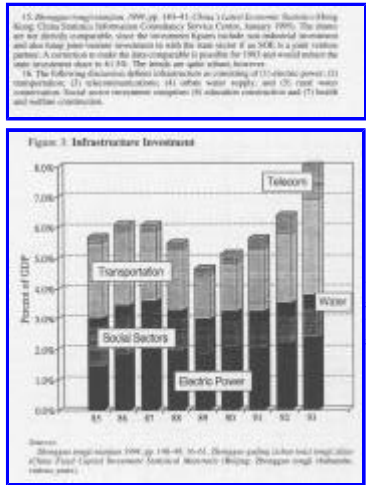


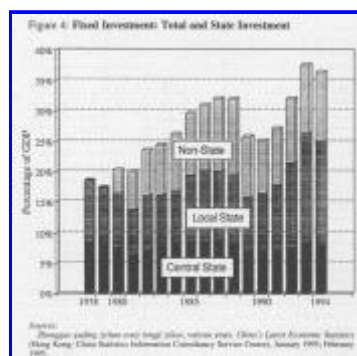
Figure 3: Infrastructure Investment

17. World Bank, *World Development Report 1994* (Washington, D.C.: International Bank for Reconstruction and Development, 1993).

18. All "new" investment in China is classified according to the level of mobilization of the enterprise with the primary responsibility for the investment project, regardless of actual financial participation, which can be more complicated.

19. Central investment in village-enterprise stock off-balance has been almost zero.





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Figure 4: Fixed Investment: Total and State Investment

Increasing infrastructure investment in the 1990s is thus part of a broader process of increasing central government intervention in the investment process. While traditional allocation of materials is no longer a significant part of SPC power, substantial instruments are used primarily to shape the flows of investment. These include:

- \* In consultation with the Ministry of Finance, setting the aggregate quantities of budgetary investment; and in consultation with the People's Bank of China, setting the quotas for bank lending for fixed investment.
- \* Allocation of budgetary grants for capital construction (technical transformation grants are allocated either by the Economics and Trade Commission or by individual ministries).
- \* Allocation of a large proportion of bank credits for fixed investment projects, the amount of which fluctuates, but has probably been above half of state bank fixed investment lending in the past two years.
- \* Allocation of that portion of foreign exchange earnings that are under central government control.

Yet the technical capabilities of the SPC are far more limited than their Japanese or Korean counterparts. In practice, the SPC is more like a broker than a steerer. It does not have detailed project planning capabilities, nor does it have great skills in project evaluation or economic analysis. There is a mis-match between capability and ambition at the SPC level.

### Pressures on the Banking System

The preceding sections have shown that there is a fundamental tension between the disappearance of government saving and continued high levels of investment in SOEs. Where does the money come from to fund state investment? Fixed investment is now predominantly funded by a combination of bank loans and various types of retained and earmarked funds. The banking system, in particular, channels financial surpluses (savings) from the household sector to the enterprise sector, a process known as "intermediation." Thus, the Chinese financial system increasingly resembles that in a developing market economy. It is entirely normal that investment be funded through a combination of retained earnings and bank credit derived from household saving balances. However, the financial system is highly distorted by the continuing pressure from the government to provide funds for its priority projects (at both central and local government levels). This is evident both in the banking system and in the disposition of retained funds. Large sums of money are retained within the government sector, either within SOEs or as various types of earmarked funds, and these are intermediated by government bodies

outside the formal banking system. Thus both the banking system and the system for using retained funds are influenced to a high degree by government officials at the central and local levels.

An overview of investment financing is provided in Table 1. In the investment statistics, various types of retained funds and informal loans are lumped into the category of "own funds" (zichou zijin), for which further detailed breakdowns are not available. However, judging from sample surveys and partial statistics, it is possible to estimate roughly the magnitude of some of these flows. Table 1 shows that almost a quarter of total investment is financed by bank loans, and half from "own funds." Within the "own funds" category, an estimated 13 per cent of total investment is raised by private firms, households and joint stock companies, that is through formal or informal capital markets. Another 18 per cent is the retained funds of SOEs. An estimated 9 per cent is "fund raising" - various forms of informal borrowing, not approved by the central government, that transfer funds from households and other businesses to SOEs. Finally, another 10 per cent comes in the form of government earmarked funds (zhuanxiang jijin). These are really quasitax revenues, quite formalized in some cases (such as electricity funds that are levied nation-wide at the rate of 2 fen per kilowatt-hour), but in other cases simply extraordinary levies imposed arbitrarily by local governments. (The three biggest formalized levies are those on electricity, railroad freight and vehicles: together they amount to over 1 per cent of GDP in extra-budgetary funds.) Thus, despite the large size of the funds deposited in China's banking system, this is only one part of the huge flow of funds into investment. Roughly the same amount flows into fixed investment outside the banking system - not counting enterprise funds used in the enterprise in which they are retained - as flows into fixed investment through the banking system. However, very little is known about this complex and diverse set of financial institutions.

The formal banking system is subject to multiple forms of government intervention. Earmarked bank loans have long been an important part of bank fixed investment lending, but there may have been a tendency for the proportion of bank lending subject to earmarking to increase in the 1990s, following the reassertion of industrial policy after 1989. The central government thus compels the banking system to provide credit for its priority projects. In this respect, the central government is no different from local governments: both put the banking system under constant pressure to provide funds for their projects. Indeed, the proportion of central and local government projects funded by bank loans is nearly identical, notwithstanding the different sectoral composition of central and local investment.

In addition, the government generally maintains fairly high levels of central bank (PBC) lending to the specialized (commercial) banks. To a substantial degree, PBC lending is offset by excess deposits maintained at the PBC by the specialized banks. Thus, PBC lending is a way to exercise control over commercial bank deposits, moving funds from one location to another in accord with central government priorities. Finally, and perhaps most important, interest rates are regulated at well below market clearing rates. In effect, the banking system is forced to subsidize government enterprises and investment projects. On balance, these add up to a very substantial reliance on the banking system by the government to substitute for its declining direct budgetary revenues.

Table 1: Financing of Total Fixed Investment, 1993  
(estimated)

Source of Finance	Percentage
Budgetary	3.7
Bank loans	23.5
Foreign investment	7.3
Own-funds (retained and raised)	50.0
of which: private firms and households	10
joint stock and co-ops	3
state and collective	37
of which: enterprise retained	18

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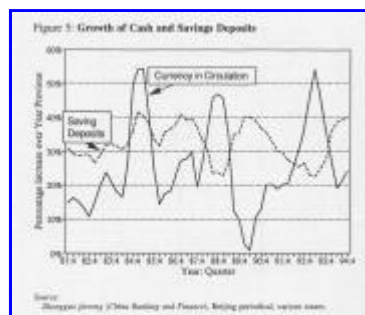
	"fund-raising"	9
	government earmarked	10
Other		15.6

Sources:  
*Zhongguo tongji nianjian*, pp. 140-41. Breakdown of own-funds based on sample surveys, see *Zhongguo jinrong nianjian 1993* (*Almanac of China's Finance and Banking 1993*), pp. 268, 277-78. See also *Zhongguo touzi nianjian 1993* (*China Investment Yearbook 1993*), pp. 16-17.

Table 1: Financing of Total Fixed Investment, 1993 (estimated)

The de facto tax rate on the banking system is thus extremely high. Depositors get less than they could earn for their funds elsewhere, and borrowers (other than favoured state clients) find their access to funds obstructed. Although the bank system provides a service in intermediating funds from savers to borrowers, the transaction is highly taxed by the government. Indeed, it is remarkable that China's household saving rate has remained as high as it is, given the low return to much of this saving. As a result of this high "tax rate," there is a strong temptation for both savers and borrowers to opt out of the formal state-run banking system and try to make deals through other kinds of institutional arrangements. When this occurs, it is called "disintermediation."

Under the current system, the disintermediation crisis is the most typical kind of financial crisis. When inflation occurs, savers are more highly taxed (because interest rates rise more slowly than does the inflation rate), and they may wish to shift into durable goods that won't depreciate with the currency. When liberalization occurs, both savers and borrowers may find new institutional forms (stocks, bonds, non-bank financial institutions, credit clubs) that allow them to circumvent the banking system with its high tax rates. When both inflation and liberalization occur at the same time (as is usual in China), the effects are particularly severe.



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Figure 5: Growth of Cash and Savings Deposits

China has experienced two very severe, very obvious disintermediation crises over the past ten years, and probably several smaller ones. The most severe ones occurred in 1988 and 1992-93. They can be clearly seen in Figure 5 as the episodes when household saving deposit growth slows or stops while currency in circulation grows rapidly. Households removed funds from the banking system and either hoarded them or put them into other types of investment. Disintermediation can also begin as funds "escape" from the banking system as individuals and organizations seize the opportunity to loan funds into high-return activities. The 1992-93 crisis was particularly interesting in this respect. At the end of 1992, the bank statistics were at their most misleading, since 120 billion yuan had been channelled through the inter-bank market and outside the banking system. They were thus "missing," and are listed on the bank balance sheet as a large negative "other" entry.

Disintermediation crises have interesting effects. They put the banking system into a severe credit squeeze, because suddenly the deposit base drops, despite the rapid growth of the price level and credit. They cannot simply be ignored. The dilemma at that point is whether the central bank should inject

additional liquidity into the system. To do so is to threaten higher inflation but not to do so is to put the banking system into an impossible squeeze. In fact, in both 1988 and 1993, the PBC did so, and there was thus a substantial jump in PBC lending precisely in those years.<sup>(20)</sup> The effect is particularly strong when policy-makers demand a special effort to provide funds for agricultural procurements, which requires additional central bank lending.

The disintermediation crisis is the characteristic form of Chinese macroeconomic imbalance, because it is the stage at which economic accountability finally emerges. Without sensitive signals from interest rates or asset markets, Chinese policy-makers do not get clear messages about the macroeconomic problems they are creating until the disintermediation crisis emerges. Even when economic problems mount, the temptation is enormous to continue to push for additional investment and more growth until the last possible moment. In practice, that moment is generally when a disintermediation crisis emerges. Then and only then are policy-makers forced to adjust their policies.<sup>(21)</sup>

### Macroeconomic Dynamics and Other Pressures

The preceding sections have sketched out a view of China's macroeconomic problems that differs from the popular wisdom both in substance and in emphasis. Instead of seeing macroeconomic difficulties as deriving from a weak central government with inadequate control instruments, it instead portrays difficulties as coming from an activist, interventionist central government with substantial power but immature financial institutions and inadequate capabilities for monitoring the economy. The popular wisdom interprets each episode of loss of macroeconomic control as a symptom of overall weakness, and suggests that it is a harbinger of a coming breakdown of control. The view presented here suggests that the short-term loss of control is due to a competition among government agencies with contradictory objectives (or possibly among competing objectives held by individual leaders). As a result, it suggests that control is likely to be re-established once macroeconomic problems compel temporary agreement that macroeconomic stability is the most important short-term objective. Indeed, that has been precisely the outcome after each inflationary episode in China, including the most recent.

The primary locus of stabilization policy has shifted to monetary policy with the onset of the reform era. However, monetary policy is subject to unrelenting pressure from government officials at both central and local levels. In essence, government officials want the banking system to extend more credit to their priority projects, and they thus create constant pressure for a more rapid growth of credit, and thus of money supply as well. In order to complete the picture, it is necessary briefly to discuss two other sources of macroeconomic instability. The first is deficit SOEs and the second is the problem of instability imported through the foreign trade account.

20. The disintermediation crisis, explained in a report to the World Bank, was interpreted there as a 4. They interpreted the high level of PBC lending in 1993 as evidence of a chronic, increasing, structural budget deficit. I suspect it is simply a one-time response to a disintermediation crisis. In the following year, 1994, PBC lending dropped almost in half. This is compatible with the disintermediation crisis explanation, but is also incompatible with the "structural deficit" explanation, or else means that the deficit was miraculously closed within a single year.

21. In 1982-83 official recognition of overvaluing was followed by Deng Xiaoping's "bustling" economic reform and rapid growth into a single package. Opposition to expansionary macroeconomic policy was converted to opposition to inflation.

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According to conventional wisdom, China's inflationary tendency results from the government propping up obsolete state-run factories. This amounts to a substantial hidden budget deficit and feeds inflation. While this story is not completely wrong, it is doubtful that it provides much explanatory power. The basic fact is that current subsidies going to state-run enterprises are moderate in size, whereas overall investment flows are very large. It is much more likely that the sources of macroeconomic imbalance lie with investment policy. Macroeconomic imbalances are the flip side of the aggressive infrastructure and industrial policy described above. Total direct government subsidies for prices and to loss-making enterprises have declined steadily during the 1990s, because of the success of price reform. In 1994

they amounted to only 1.5 per cent of GDP, by far the lowest since the beginning of reform. There are without doubt significant hidden subsidies going to state industry, in the form of guaranteed access to relatively cheap credits. But even here caution must be observed. The total increment in credit to industrial enterprises from the state banking system in 1993 was 3.5 per cent of GDP. In addition, there are substantial subsidies in the form of low interest rates - which are very large when inflation is high and real interest rates significantly negative, but moderate when inflation is low and real interest rates poke into the positive range. All together, if current subsidies to the state sector amount to 3 or 4 per cent of GDP (a generous estimate), this is certainly wasteful, but is simply not enough continuously to tip the economy into an inflationary spiral, not when it is generating saving at the rate of over 35 per cent of GDP, as China is.

Nevertheless, SOEs represent a burden on the banking system, and thus are a factor tending to destabilize macroeconomic policy. According to a recent statement by Chen Yuan, vice-head of the PBC, about a fifth of the state banking system's loans are overdue (but still paying interest), and about 3 per cent of loans have been classified non-performing. Most of both categories are loans to SOEs.<sup>(22)</sup> These numbers represent real challenges to the banking system. Great care must be taken to clean up the bank balance sheets properly, write off non-performing loans and put the banks in a healthy position so they can compete in the new market economy.

Why is the assessment of the SOE problem in this article so different from the popular wisdom? First, the popular wisdom does not adequately distinguish between support for SOEs as a waste or as an obstacle to improving efficiency on the one hand, and support for SOEs as a source of macroeconomic instability on the other. In examining the macroeconomic impact of a government action, the crucial question is not whether the activity is wasteful, but rather whether the action is adequately funded. If a real use of resources is not adequately funded, it will be inflationary to the extent that the government ends up "printing money" to support the activity. Some support for SOEs undoubtedly does come in this form, but although the amount is not really known, it is probably not large. The bigger expenditure is in the form of loss-making enterprises, and most of those losses are fully funded by deductions from profits which would otherwise be remitted to the government. Secondly, the popular wisdom is overly influenced by imprecise statements from Chinese sources. Complaints about SOE losses have been expressed in China for over 15 years, but the nature of the phenomena complained about has changed dramatically. Throughout the 1980s, the overwhelming majority of SOE losses were incurred by commercial units supplying food to urban dwellers. What were then labelled "SOE losses" were in fact policy-determined payments to urbanites. In the 1990s, those losses have been nearly eliminated by price reforms. Meanwhile, industrial SOE losses, which were insignificant in the 1980s, have become substantially more important, though they are only a fraction of the magnitude of the earlier food subsidies. Government officials are naturally concerned because they are used to treating industrial SOEs as their "cash cows." Moreover, as state employees themselves, government officials are understandably somewhat obsessed with the tough problem of how to restructure SOEs without creating mass unemployment. But these very real issues do not necessarily imply that SOEs are a destabilizing factor in the economy.

22. Associated Press, "China banks to go commercial" 20 June 1995, cited China News Page.

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Finally, the popular wisdom lumps all SOEs into a single category. In fact, as shown in Figure 2, SOEs are evolving in different directions in different sectors. In certain sectors in which SOEs are dominant including electricity generation, steel making and cigarette production SOEs continue to be highly profitable. In others, including coal and petroleum extraction, losses are substantial partly because of



continued government distortions of the price structure. On balance, SOEs are a significant obstacle to further economic reform and improved efficiency. Privatization could begin immediately and be carried out quickly in the competitive sectors. Progress in non-competitive sectors would be slightly slower, since a regulatory framework needs to be created in those areas. But there is no reason not to proceed with privatization and rapid restructuring of SOEs. Conversely, though, there is no reason to believe that the continued presence of SOEs prevents urgently required financial reforms, or makes macroeconomic stability impossible.

A second factor that can destabilize the macroeconomy in today's China is exchange rate policy, which was particularly important in 1994. On 1 January 1994, China devalued and unified the currency at a rate around 8.7 RMB to the dollar. For most purposes this was a substantial devaluation. China's exports responded to the stimulus, and the trade balance swung from a deficit of \$12.2 billion to a surplus of \$5.35 billion. The magnitude of the change can be better appreciated if only "ordinary" trade is looked at. This is caned out primarily by Chinese foreign trade corporations (FTCs), setting to one side the roughly 30 per cent of China's exports carried out by foreign invested enterprises (FIEs). FIE exports are important, but are not highly sensitive to the exchange rate in the short term because they import a large share of their inputs. By contrast, ordinary exports are highly sensitive to exchange rate fluctuations. During the first eleven months of 1994, ordinary exports increased 42 per cent, while ordinary imports actually declined 5.4 per cent, so the surplus on ordinary trade jumped to \$26 billion from a little over \$6 billion.(23) This dramatic shift resulted in a huge inflow of income from foreign trade.

In the face of this inflow, the Chinese government had a number of alternatives. It could have allowed the RMB to appreciate (that is, allow its value to increase relative to the dollar, since dollars were less scarce and less valuable), undoing some of the devaluation at the beginning of the year and eventually shrinking the trade surplus. Secondly, it could have encouraged imports, which would have had some benefits: increased import of grain would have moderated inflationary pressures created by the year's poor harvest, and increased imports from the United States would have reduced trade tensions. The government actually pursued a third option, which was to buy with RMB the dollars earned by exporters, thus increasing foreign exchange reserves and maintaining a stable exchange rate. China's foreign exchange reserves increased 140 per cent during 1994, to reach \$51.6 billion, and jumped to \$58 billion by the end of March 1995. Thus foreign exchange reserves increased by a total of about \$30 billion in 1994, roughly equivalent to the surplus on ordinary trade. At 8.5 RMB to the dollar, this means that the government injected about 250 billion yuan RMB into the domestic economy.

With the central bank pumping a substantial amount of money into the economy to purchase foreign exchange reserves, it had little or no leeway to create money by extending new central bank loans. Indeed, on the central bank balance sheets, the increase in new foreign assets (foreign exchange reserves) accounted for 87 per cent of base money creation during the first eleven months of 1994.(24) The central bank made very little money available in new domestic central bank lending. In that sense, monetary policy was quite tight. Total credit (state banks plus rural credit co-operatives) increased at the moderate rate of 20 per cent in 1994. This explains the phenomena of 1994 and 1995. Money supply growth has been fairly rapid - M2 grew 34.4 per cent in 1994 and currency in circulation grew 24 per cent - yet the banks proclaim that they are following a tight monetary policy and enterprises complain about the difficulty in getting bank loans.(25) In fact, the domestic economy faces relatively tight money, while the export sector is awash with liquidity. This helps to resolve the paradox raised in the first paragraph of this article: China's "soft landing" after the July 1993 initiation of **austerity** policies took so long because it conflicted with the inflationary forces emanating from the export sector.

## Some Implications and Conclusion

There are some clear implications to the preceding analysis. First, the attempt by the government to steer the economy and commandeer resources from the banking system is the ultimate source of macroeconomic imbalance. The imbalances occur not so much because of the continuing cost of propping up a state sector, but rather because the government is committed to maintaining very high rates of new investment in priority sectors, but doesn't have the direct command over resources to pay for it. Moreover, it is currently locked into a difficult set of interactions. It has been "successful" in pumping up large investments in key infrastructure sectors. That has allowed growth to accelerate and insured the profitability of non-infrastructure investments, typically made by decentralized agents. But as inflationary problems increase, the government's investment effort may prove to be unsustainable. With direct control concentrated on infrastructure investment, any **cutbacks** in central government control will first affect infrastructure investment, and may therefore aggravate bottlenecks and imbalances. There may be a rapid fall from the high-growth path which China has followed for the past few years.

Secondly, given the lack of accountability in the system, the result is likely to be a continued series of macroeconomic crises, as the government continually runs up against the limits of what it can exact from the economy as a whole, and from the financial system in particular. Difficulty in controlling the economy is not caused by an absence of control instruments. Indeed, the Chinese government has repeatedly shown the ability to impose **austerity** programmes, reduce the growth of bank credit and ultimately bring inflation down, but its resources to those instruments is delayed until after the crisis is full-blown. The real problem is the absence of day-to-day restraint that prevents crises from emerging.

21. Yan Rong, "An analysis of 1994 balance of payments and a projection for 1995," *Zhongguo jingji*, No. 4 (1995), pp. 70-80.  
22. *Ibid.* p. 80.  
23. Monetary data from *Zhongguo jingji*, No. 7 (1995), pp. 99-101.

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Thirdly, policy-makers in China have already recognized that financial reform is one of the most crucial and most urgent needs of current reform. Indeed, the basic outline of a direction for financial sector reform was passed with the Banking Law of 1995. This set out a vision of independent commercial banks not subject to government intervention. In order to help implement this vision, the State Development Bank and two other government "policy lending" banks were created during 1994 to assume the burden of government-directed loans. Yet it is clear that it will take far more than a simple declaration of principles to implement banking reform effectively. In the first place, the banking system continues to be under pressure from the government's conflicting objectives (indeed, sometimes from the conflicting objectives of different parts of the government). Even if the State Development Bank succeeds in taking over a large portion of the government-directed lending of the commercial banks, it will require a major commitment to prevent central and local government agencies from imposing new lending requirements on the commercial banks. Moreover, banks will inevitably need some facility for restructuring their existing loans, giving them a mechanism to write off bad loans or transfer them to a new facility. Finally, some commitment to liberalize interest rates significantly will be required to make the vision a reality.

Development of capital markets had lagged behind because it is difficult; because there are still ideological obstacles; and because government officials want to retain the power to influence investment and are thus ambivalent about future reform. A foreshadowing of the difficulties of financial sector reform is apparent in the failure of government efforts to shift the investment system to repayable grants. The government has received very little in the form of repayment for past investment in this

form.(26) In the financial arena, perhaps more than in other areas, successful reform appears to require a substantial, sustained exertion of political will by a committed central government. In both the banking system and the taxation system, nominal reforms have already been adopted that outline the basic steps required. The question is whether the political system can generate sufficient unity of purpose to make implementation of those reforms a reality.

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